

Internal Revenue Service

Number: **201741005**
Release Date: 10/13/2017
Index Number: 167.22-01

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
 , ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B06
PLR-104761-17
Date:
July 17, 2017

LEGEND:

Taxpayer	=
Parent	=
State	=
Commission A	=
Commission B	=
Operator	=
Date 1	=
Date 2	=
Date 3	=
Form	=
Director	=

Dear :

This letter responds to Parent's request, made on behalf of Taxpayer, dated February 1, 2017, for a ruling on the application of the normalization rules of the Internal Revenue Code (Code) to certain accounting and regulatory procedures, as described below.

The representations set out in your letter follow.

Taxpayer, a wholly-owned subsidiary of Parent, is an investor-owned regulated utility incorporated in State. Taxpayer is a member of Parent's consolidated group that files a consolidated federal income tax return on a calendar year basis using an accrual method of accounting.

Taxpayer is engaged in the purchase, transmission, distribution, and sale of electric energy in State. It is subject to regulation by Commission A and Commission B, with respect to terms and conditions of services, including the rates it may charge for its

services. Both Commissions establish Taxpayer's rates based on its costs, including a provision for a return on the capital employed by Taxpayer in its regulated business. Taxpayer's electric transmission lines located in State are integrated into Operator, a regional transmission operator. As a transmission-owning member of Operator, Taxpayer is able to include in Operator's tariff a rate that allows it to recover the costs it incurs with respect to the transmission facilities it makes available to Operator. The rate-setting mechanism used by Taxpayer is a formula rate approved by Commission B. The formula rate is established in two parts: a basic rate and a true-up.

By Date 1 of each year, Taxpayer files with Commission B to update its formula rate. The new rate takes effect on Date 3 of the same year and remains in effect for one year, until Date 2 of the following year. The data used in calculating the basic rate portion of the updated rate is, for the most part, taken from the historical test year which ended on the last day of the immediately preceding calendar year (as reflected in Taxpayer's Form for that period). All elements of rate base, including plant in service, accumulated depreciation and accumulated deferred federal income taxes (ADFIT) use, at least initially, "end of historical calendar test year" balances. Depreciation expense (and all other operation and maintenance expenses) reflected in the calculation are also historical calendar test year expense amounts.

One element of the calculation is then modified. A projection is made of plant additions expected to be placed in service during the calendar year in which the rates are being set. The cost of these additions is weighted to reflect the number of months each addition will be in service during the calendar year. This weighted amount is added to rate base. Thus, this component of the rate provides a return on the equity reflected in the projected plant additions being included in rate base. No modification is made to the balances of the depreciation expense or deferred taxes due to these projected plant additions. The basic rate is a revenue requirement calculated based on the historical calendar year test period data so modified.

The true-up component of Taxpayer's formula rate is calculated by comparing a revenue requirement computed based on Taxpayer's most recent Form to the revenue requirement originally calculated for the prior test period. Any difference, both over- or under-recoveries (plus interest), is incorporated into the formula rate as the true-up component of that rate. Among other things, this component corrects any over- or under-recovery of equity return arising from the prior year's projection of plant additions, based on actual plant additions during the year.

Taxpayer has claimed (and continues to claim) accelerated depreciation on all of its public utility property to the full extent those deductions are available under the Code. Taxpayer normalizes the federal income taxes deferred as a result of its claiming these deductions in accordance with the Normalization Rules. As a consequence, Taxpayer has a substantial balance of ADFIT that is attributable to the accelerated depreciation reflected on its regulated books of account. In its formula rate template, Taxpayer

reflects its ADFIT balance (as appropriately allocated to the jurisdiction) as a reduction in its computation of rate base.

In calculating both its basic rate and its true-up, the ADFIT balance by which Taxpayer reduces rate base is the end of period balance (i.e. the ending balance as reflected in Taxpayer's Form for the calendar year immediately preceding the year in which rates are being updated). Because ADFIT is not projected in either component, Taxpayer neither averages nor applies the proration methodology to the ADFIT balance in either calculation.

Taxpayer requests that we rule as follows:

1. Taxpayer's projection of plant additions for inclusion in rate base in conjunction with the use of historical ADFIT and depreciation expense in computing its basic rate is not a violation of the Consistency Rule;
2. If the Service rules adversely with respect to Requested Ruling 1, provided that Taxpayer takes the necessary corrective action at the next Form filing following the effective date of any related tariff changes approved by Commission B, any failure by Taxpayer to comply with the Consistency Rule in connection with its formula rate at any time prior to the Taxpayer taking the necessary corrective action was not a violation of the Normalization Rules; and
3. If the Service rules adversely with respect to Requested Ruling 1, incorporating projected ADFIT (on a prorated basis), depreciation expense, and tax expense relating to the projected additions included in the formula rate calculation going forward will satisfy the Consistency Rule.

Law and Analysis

Requested Ruling 1

Former section 167(l) generally provided that public utilities were entitled to use accelerated methods of depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 168(f)(2) provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A) requires that a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

In order to satisfy the requirements of § 168(i)(9)(B), there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. In this case, all elements of rate base, including plant in service, accumulated depreciation, and ADFIT use, at least initially, "end of historical calendar test year" balances. Depreciation expense (and all other operation and maintenance expenses) reflected in the calculation are also historical calendar year test year expense amounts.

Taxpayer uses a projection of plant additions that will be placed in service during the calendar year in which rates are being set to compute a weighted amount that is added to rate base. The addition of the projected plant additions to rate base provides a return on the equity reflected in these projected plant additions. No modification is made to depreciation expense or deferred taxes as a result of these expected additions to Taxpayer's equity. Taxpayer's tax expense, depreciation expense, and ADFIT are all calculated in a consistent fashion. Therefore, Taxpayer is not in violation of the Consistency Rule.

Because of the conclusion reached above, Taxpayer is also not in violation of the Normalization Rules. Accordingly, Taxpayer's Requested Issues 2 and 3 are moot and

will not be considered further.

Conclusions

1. Taxpayer's projection of plant additions for inclusion in rate base in conjunction with the use of historical ADFIT and depreciation expense in computing its basic rate is not a violation of the Consistency Rule.

2. This issue is moot as discussed above.

3. This issue is moot as discussed above.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Patrick S. Kirwan
Chief, Branch 6
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

CC: